No. 12302.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

CAPITAL SERVICE, INC., a Corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY BRIEF OF PETITIONER.

FILED

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REPLY BRIEF OF PETITIONER.

I.

Petitioner and Respondent Are in Accord as to the Issue to Be Decided in This Appeal.

Respondent has indicated (Resp. Br. 14) that it is in accord with petitioner's statement as to the issue involved in the instant case:

> "The sole question to be decided in this appeal is whether petitioner sustained in the calendar and taxable year 1942 a net operating loss, as defined in Section 122(a) of the Internal Revenue Code (26 U. S. C. A., section 122(a)), which may be carried over and used as a net operating loss deduction for the calendar and taxable year 1943, as provided for by Section 122(b)(2) of the Internal Revenue Code (26 U. S. C. A., section 122(b)(2)).

"The determination of the question presented depends upon whether the indebtedness of $31,567.81 owed to petitioner by, and stock at an adjusted cost basis of $1,300 held by petitioner in, the Central California Utilities Corporation became worthless during the calendar and taxable year 1942, as contended by petitioner, thus permitting deductions to be made from the gross income of petitioner for the year 1942 under the provisions of Sections 23(k) and 23(f), respectively, of the Internal Revenue Code (26 U. S. C. A., Sections 23(k) and 23(f)), or prior to said calendar and taxable year, as contended by respondent." (Pet. Br. 5.)

II.

The Decision of the Tax Court, which Is Based Upon a Finding That the Stock and Debt of Central Became Worthless Prior to 1942, Is Not Supported by Any Evidence.

A. Preliminary Statement.

Respondent contends that the decision of the Tax Court sustaining the determination of respondent is supported by substantial evidence, and frequently adverts to the well recognized rule that the decision of a lower court is conclusive upon review, if supported by substantial evidence. (Resp. Br. 13, 20.) However, it is one thing merely to assert that substantial evidence exists, and quite another to refer to the record below and point out such evidence.

Petitioner respectfully urges herein that the decision below is not only not supported by substantial evidence, but is supported by no evidence at all.

B. Point by Point Consideration of the Evidence Which Respondent Contends Specifically Shows Worthlessness of the Stock and Debt of Central Prior to 1942.

Let us carefully scrutinize the evidence adduced below, which respondent contends (Resp. Br. 17-20) specifically shows worthlessness of the stock and indebtedness of Central prior to 1942:

> (a) "Kettleman's only gas well blew out early in 1935 thus depriving Gas Fuel of gas to supply its 10 or 12 customers. [R. 96, 299, 397.]" (Resp. Br. 17.)
>
> (b) "The serious financial difficulties by the end of 1935 of Inland, Gas Fuel and Kettleman—taken over by Central in 1936 [R. 394-395]—showed that their combined liabilities exceeded their assets by more than $58,000, and that their lands, leases and wells of a book value in excess of $1,100,000 were eliminated by quitclaims and abandonment as of December 31, 1935. [R. 283-285, 288-289, 398.]" (Resp. Br. 17.)

Comment on Items (a) and (b):

It is to be noted that the events referred to in (a) and (b), *supra,* occurred *prior* to the formation of Central. The respondent at no place in the record introduced evidence, or even inferred, that the stock and debt of Central were worthless immediately upon its formation in 1936; nor did the Tax Court in its decision so rule. The Tax Court, in its opinion [Tr. 409], although it does not pin-point the year in which it concluded that the two items became worthless, uses verbiage, the flavor of which suggests that the Court looked upon 1939 or 1940 as the

year in which worthlessness occurred. Respondent in another portion of its brief (Resp. Br. 22) states:

> ". . . it is plain that there were many identifiable events demonstrating that both the stock and indebtedness in question were utterly worthless at least after December 31, 1939, and in any event at the end of 1941."

It seems clear that respondent in citing the events referred to in (a) and (b), *supra,* as events specifically showing worthlessness of the stock and indebtedness of Central, prior to 1942, has adopted a position not relied upon by the Tax Court itself, and one in which respondent itself has no conviction.

> (c) "The reorganization plan in 1936, under which Central was created to take over and operate the business of Inland [R. 394-395], and whereby the taxpayer acquired an additional 1,050 of Central's shares, proved totally unsuccessful [R. 205-207, 210, 298-299, 398-399, 400-403, 407-409; Pet. Br. 12.]" (Resp. Br. 17.)

Comment on Item (c):

Respondent here attempts to use as a "fact" showing worthlessness of the stock and indebtedness of Central, prior to 1942, a situation not borne out by the record below. *"Operations" were never the purpose of petitioner with respect to Central. Petitioner was interested only in a speculative profit.* [Tr. 318-319, 330.] The loan that petitioner had made to the Central system was given for the purpose of placing that system in a condition in which it could be publicly financed, through sale of the

authorized, but unissued, shares of Central, or in a posture which would enable petitioner to sell its stock interest to other managers, who would themselves attempt to finance the enterprise. [Tr. 232-234, 320.]

It seems clear that the fact that the speculation in which petitioner engaged ultimately failed, is not a fact which *specifically* shows worthlessness of the stock and indebtedness of Central prior to 1942.

> (d) "The taxpayer advanced large sums to Central during 1936 and 1937, and a final advance of only $50 in January, 1938, resulting in a net indebtedness, never paid, of $31,567.81 owed by Central as of April 30, 1940 [R. 73-75]. This amount, however, the taxpayer, despite the absence of *anything* showing value after the end of 1940 [R. 359-361, 408-409], was not charged off as a loss by the taxpayer until December 31, 1941 [R. 399-400]." (Resp. Br. 18.)

COMMENT ON ITEM (d):

The government here is urging the premise that because the indebtedness of Central was never paid, obviously a hindsight fact, we may conclude that the indebtedness became devoid of all value, including potential value, prior to 1942!

The respondent also concludes, and it is merely a conclusion, that the indebtedness of Central owing to petitioner, was valueless after the end of 1940. Respondent obviously has chosen to overlook the basic elements of the Central enterprise, which existed continuously from 1936 to 1942, and which had originally aroused the interest of

petitioner in the Inland-Central system: (1) The certificate of public convenience and necessity which gave Central, through Fuel, its subsidiary, the right to distribute and sell natural gas in Fresno and Kings counties; (2) the supply of natural gas in the area; and (3) the potential market for that gas in Fresno and Kings counties. [Joint Ex. No. 1-A, Tr. 32; Joint Ex. No. 2-B, Tr. 49; Joint Ex. No. 7-G, Tr. 71; Tr. 94-95, 99, 100, 111-112.] Petitioner will further discuss the potential value of the certificate of public convenience and necessity, *post*. Suffice it to say here that the aforementioned *conclusion* of respondent can in no wise be determinative.

(e) Respondent lists the following facts found by the Tax Court as the remaining facts specifically showing worthlessness of the stock and debt of Central, prior to 1942:

1. Kettleman's lack of success in bringing in gas wells upon land leased by it. (Resp. Br. 18.)
2. Fuel's discontinuance of its purchases of gas from Southern California Gas Co., because of the lack of efficiency of the gas distribution system. (Resp. Br. 18.)
3. Central's failure to distribute gas after 1937. (Resp. Br. 18.)
4. Central's obtaining of permission from the California Railroad Commission to temporarily discontinue service under its certificate of public convenience and necessity, in 1938. (Resp. Br. 18.)
5. The sale of the physical assets of Fuel and Kettleman in 1939. (Resp. Br. 18-19.)

6. Suspension of the corporate charters of Central, Fuel, and Kettleman in 1940. (Resp. Br. 19.)

7. The letter of Ralph Moore, dated December 2, 1940, in response to a letter written to Moore on November 22, 1940, by an agent of the Bureau of Internal Revenue. (Resp. Br. 19.)

Items 5-7 have been discussed at length in the opening brief of petitioner, and will be discussed *post* in the light of argument made in the brief of respondent.

Items 1-4 are findings which do not support the ultimate finding of the court below that the stock and debt of Central became worthless prior to 1942.

At the risk of being repetitious, petitioner desires to emphasize that in its dealings with the Central system, it was engaging in a *speculation* of the type familiar in our economy. [Tr. 192-195, 218, 224, 232-234, 320.] It had been determined that in Fresno and Kings counties, a need existed for an inexpensive source of power for irrigation pumping purposes. [Tr. 37-38.] It was also found that natural gas, a commodity which could be used in satisfying this need, existed in abundance in the same area. [Tr. 87, 94-100.] Petitioner sought to *organize* a natural gas utility system, which was to operate under the certificate of public convenience and necessity possessed by Fuel. Petitioner expected to profit ultimately by a sale of the promoter's stock which it held in Central. [Tr. 318-319, 330.]

Petitioner was in no sense interested in the Inland-Central system as a presently operating utility. The basic reason for supplying the 10 or 15 customers who formerly had been served by the Inland system, was to insure the retention of the certificate of public convenience and nec-

essity, which, in petitioner's considered estimation was the keystone of the entire enterprise. (Pet. Br. 29-32.) When the danger of rescission of the certificate was lessened by permission of the California Railroad Commission to temporarily discontinue service, petitioner used this opportunity to cease the above mentioned minimal function entirely. (Pet. Br. 15.)

The Tax Court and respondent have taken the evidence adduced by petitioner, and attempted to place it within a frame of reference which the record will not support. To view the Central system as small operating utility, the stock and debts of which became worth successively less, as it ceased to function, and disposed of its physical assets, is to distort completely the objective, factual situation, which reveals that the Central enterprise was a speculation at the outset in 1936, and remained so until 1942, in which year the basic elements upon which the speculation was based, were markedly altered. [Tr. 232-234, 320, 322, 350-351.]

C. The Letter Written to Ralph Moore on November 22, 1940, by an Agent of the Bureau of Internal Revenue, and Moore's Letter in Response Thereto Dated December 2, 1940.

The decision of the Tax Court is to a large extent based upon the material contained in Ralph Moore's letter of December 2, 1940. [Tr. 409.] Respondent also places heavy reliance upon this letter in its brief. (Resp. Br. 19, 27.) In its opening brief, petitioner carefully pointed out that there is serious doubt, as a matter of law, whether Moore was impeached by cross-examination with respect to the contents of the aforementioned letter. (Pet. Br. 35-36.) Petitioner argued in its opening brief that even if

it may be concluded that Moore was impeached, the court below could not properly use the contents of Moore's reply letter as evidence of the value of the stock of Central, for the following reasons: (1) Moore was not qualified as an expert witness with respect to the question of the value of the stock, and (2) prior inconsistent statements of witnesses, used for purposes of impeachment, may not be treated as having independent testimonial value. (Pet. Br. 36-38.)

It is to be noted that respondent has in no wise attempted to argue the legal propositions raised by petitioner against the use of this evidence to support the decision below. It is respectfully submitted that reliance upon the contents of the letter of Ralph Moore is erroneous, and that said evidence may not properly be cited in support of the determination of the Tax Court.

D. The Value of the Certificate of Convenience and Necessity Possessed by the Central System.

Respondent devotes a good deal of attention in its brief to the question of the value of the certificate of convenience and necessity possessed by Fuel. (Resp. Br. 25-31.) Petitioner in its opening brief discussed the failure of the Tax Court to appraise fully the value of this asset. (Pet. Br. 30-32.) Petitioner now will meet the argument of respondent with respect to this issue.

Respondent espouses the following thesis: "The certificate could have had no greater value than its demonstrated ability to produce earnings. . . ." (Resp. Br. 25.) On its face, respondent has adopted a measure for determining actual or intrinsic value. While "demonstrated ability to produce earnings" may be a proper test for the ascertainment of intrinsic value, it is of no as-

sistance in the determination of whether an asset has potential value.

Respondent, on page 26, *et seq.,* of its brief, displays the erroneous basis upon which it seeks to uphold the decision below. Respondent suggests that the following factors show the absence of potential value in the certificate:

(1) The certificate was of such nature as to be clearly not negotiable or saleable by its possessor (Resp. Br. 26);

(2) Gas Fuel was without gas supply, and without the possibility of obtaining a gas supply, and financial aid to construct a new gas distributing system after 1939 (Resp. Br. 26);

(3) Petitioner's statements on page 26 of its opening brief that: "Petitioner *never* had at its disposal funds in the amount that would have been necessary to develop a gas utility system on the scale contemplated by petitioner and Moore" and that "Petitioner's capital resources were decidedly limited, and thus petitioner could not materially alter the status of Central." (Resp. Br. 26);

(4) The certificate of convenience and necessity had no intrinsic or potential value after the suspension in 1940 of the charters of Fuel, Central and Kettleman (Resp. Br. 29-31).

Petitioner respectfully submits that the aforementioned conclusion with respect to the absence of potential value in the certificate, based upon the foregoing factors, is not only a logical *non sequitur,* but is not borne out by the evidence set forth in the record below.

Respondent has adopted a completely impractical position in asserting that the certificate was not negotiable or saleable by its possessor, in view of its having been granted by the State, according to the needs of the community. Petitioner at no time intended to transfer the certificate itself—it planned to sell its *stock interest* in Central, which latter company owned the stock of Fuel, as well as Kettleman. [Tr. 318, 319, 330.] Thus, lack of negotiability of the certificate is a factor that need not be discussed further.

Respondent takes the position that Fuel was without the possibility of obtaining a gas supply after 1939. Respondent at no place in the record introduced evidence establishing that a supply of gas was not available in the oil rich areas of Fresno and Kings counties. However, petitioner introduced evidence clearly establishing that the physical availability of natural gas was not a problem for the Central system until the year 1942. [Tr. 100, 176-179, 350-351.]

Thus, Roy M. Bauer, expert witness of petitioner, who stated that a corporation which held on January 1, 1942, a certificate of public convenience and necessity to distribute natural gas in Fresno and Kings counties, and also

had the possibility of raising funds, either through public or private financing, and had a source of gas supply, at prices enabling it to sell at a profit, and also a potential supply of customers in the area, was the possessor of an asset of *potential* value, arrived at a conclusion with respect to an hypothetical question the basic factors of which were borne out by the evidence. [Tr. 340-344.]

In its footnote on pages 26-27 of its brief, respondent raises the point that Bauer had no personal knowledge of the Central system, and therefore had to testify on the basis of *assumed* facts. It must be pointed out that expert witnesses *must*, as a matter of law, testify upon the basis of hypothetical or assumed facts. *Permanente Metals Corp. v. Pista* (1946 U. S. C. A. 9th), 154 F. 2d 568, 569.

Respondent is unrealistic in its assertion that the fact that petitioner did not have sufficient funds at its disposal to develop the Central system indicates an absence of potential value in the certificate. Petitioner must again assert that respondent, in making such a statement completely avoids the evidence which establishes that petitioner was engaged in a speculative enterprise—that petitioner sought capital from public and private sources, for the primary purpose of enabling it to dispose of its stock interest in Central at a profit. [Tr. 232-234, 320.]

Respondent also devotes a substantial portion of its brief to the thesis that the certificate of convenience and necessity had no intrinsic or potential value after the sus-

pension in 1940 of the corporate charters of Fuel, Central, and Kettleman, for non-payment of corporate franchise taxes. (Resp. Br. 29-31.) It is to be noted that the suspension of said charters, which is fully discussed in petitioner's opening brief, did not affect the certificate possessed by Fuel, which remained in full force and effect, until October 6, 1942. [Pet. Br. 33-34; Tr. 71.]

Respondent's emphasis upon the matter of the suspension of corporate charters seems highly impractical, in view of the fact that whatever disability was caused by said suspension could have been quickly remedied under local law by payment of the delinquent taxes. (Pet. Br. 33-34.)

It would thus appear, that as a practical matter, and the United States Supreme Court has ruled that in this type of case, the practical approach should be adopted (*Boehm v. Commissioner*, 326 U. S. 287, 293, 66 S. Ct. 120, 124), the entire discussion of the "drastic" effects of the suspension of the corporate charters of Fuel, Central, and Kettleman upon the value of the certificate of public convenience and necessity, is rendered moot.

Respondent's conclusion (Resp. Br. p. 30) that the certificate was abandoned, in effect, after the suspension of the corporate powers of Fuel, has no foundation in the record. [Pet. Ex. No. 28, Tr. 165; Pet. Ex. No. 29, Tr. 172; Tr. 164-165, 170-172, 173-177, 238-240.] The continued efforts of petitioner to realize upon the stock and debt of Central, which efforts had as their basis the certificate possessed by Fuel, refute the conclusion of abandonment. Respondent adverts, in support of its contention of abandonment, to Petitioner's Exhibit No. 26, in which the Railroad

Commission mentioned, in a letter directed to Central, that one of its engineers had been advised that Fuel intended "to permanently abandon gas service." Respondent should have also called attention to the letter dated March 25, 1941, in response to the aforementioned letter of the Railroad Commission, in which Central denied that it was abandoning the certificate and affirmed the existence of negotiations "looking forward to the possible resumption of the Gas Fuel Service Company under its franchise." [Pet. Ex. No. 27, Tr. 163.]

III.

Statement With Respect to the Identifiable Events Upon Which Petitioner Relies to Fix the Worthlessness of the Stock and Debt of Central in the Year 1942.

Respondent has stated in its brief that petitioner contends that formal revocation of the certificate of Fuel on October 6, 1942, was the identifiable event which indicated *complete extinguishment* of all value, and fixed the worthlessness, of the stock and debt of Central in that year. (Resp. Br. 25.)

Petitioner wishes to correct this misconception on the part of the government, and directs the attention of the Court to page 50 of its opening brief on appeal, in which petitioner has carefully set forth the sudden changes in the economic outlook which occurred in 1942, and which drastically affected the speculation in which petitioner had engaged. Petitioner contends that the formal act of

revocation of the certificate of public convenience and necessity is just one of the identifiable events which fix the loss on the stock and debt of Central in the year 1942. The other identifiable events upon which petitioner relies are: (1) The disappearance of surplus gas in the area of Fresno and Kings counties in 1942, due to war needs, and (2) the practical impossibility in 1942 of obtaining capital for a basically non-war enterprise which could not be converted to war use.

IV.

The Tax Court, in Making Its Decision, Did Not Apply the Correct Principles of Law.

It is to be noted that respondent presents no argument in opposition to petitioner's contention in Point III of its opening brief that the Tax Court, in making its decision, did not apply the correct principles of law. Respondent summarily dismisses the cases cited in Point III-C of petitioner's opening brief, on the ground that since we are dealing with a question of fact in this appeal, "precedents involving distinctive facts are of no great value." (Resp. Br. 31.) Respondent has obviously failed to recognize that the cases cited by petitioner in Point III-C are cited not primarily for the factual situations therein presented, but to demonstrate the proposition that the Tax Court, in the instant case, failed to apply recognized principles of law, applicable to all cases involving the question of stock and debt worthlessness.

Conclusion.

Petitioner respectfully submits that the decision of the Tax Court, sustaining the determination of respondent that a deficiency in income tax in the amount of $7,358.10 is owing by petitioner for the calendar and taxable year 1943, is clearly erroneous, and ought to be reversed and set aside.

Respectfully submitted,

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APPENDIX.

Statutes Cited in the Reply Brief.

Section 23, Internal Revenue Code. DEDUCTIONS FROM GROSS INCOME (26 U. S. C. A., Sec. 23):

> "In computing net income there shall be allowed as deductions:
>
> . . . (f) *Losses by Corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.
>
> . . . (k) *Bad Debts.* (1) *General Rule.* Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. This paragraph shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection. This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined in paragraph (4) of this subsection."

Section 122, Internal Revenue Code. NET OPERATING LOSS DEDUCTION (26 U. S. C. A., Sec. 122):

> "(a) *Definition of Net Operating Loss.*—As used in this section, the term 'net operating loss' means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) *Amount of Carry-back and Carry-over.* . . . . . . (2) *Net operating loss carry-over.*—If for any taxable year the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the two succeeding taxable years, except that the carry-over in the case of the second succeeding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the intervening taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d)(1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such intervening taxable year without regard to such net operating loss and without regard to any net operating loss carry-back. For the purposes of the preceding sentence, the net operating loss for any taxable year beginning after December 31, 1941 shall be reduced by the sum of the net income for each of the two preceding taxable years (computed for each such preceding taxable year with the exceptions, additions, and limitations provided in subsection (d)(1), (2), (4), and (6), and computed by determining the net operating loss deduction without regard to such net operating loss or to the net operating loss for the succeeding taxable year)."